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TAGS: EFIN ECON RS
SUBJECT: RUSSIA'S "SAFE HAVEN" STATUS SLIPPING?

REF: MOSCOW 1616

Classified By: Acting DCM Eric T. Schultz, Reasons 1.4 (b/d).

Summary

¶1. (C) In contrast to Russia's record-setting financial performance for 2007 and high hopes for 2008, the results from the first half of 2008 have revealed signs of strain. Net capital inflows are down substantially, as are Initial Public Offerings (IPOs), which through June have totaled only USD 500 million, compared to USD 15 billion during the first half of 2007. General uncertainty about the economic resilience of emerging markets explained part of the drop-off according to Merrill Lynch-Russia Chief Economist Yulia Tsepliaeva. Goldman Sachs Executive Director for Economic Research Rory MacFaquhar suggested that inflation concerns were the primary cause of the decreases. These results may tip the scales in Finance Minister Kudrin's inflation-fighting favor when budget amendment season begins in September. End Summary.

High Hopes for 2008; Disappointing Results

¶2. (U) Amidst global financial uncertainty, particularly among developed market economies, the steady climb of oil prices, increasing corporate profitability, and a strengthening ruble prompted officials and observers alike in January to begin referring to Russia as a potential financial safe haven while developed markets resolved the various issues stemming from the sub-prime induced liquidity squeeze. Russian officials forecast year-end inflation at 10.5 percent, and investment analysts predicted the benchmark RTS index would grow by 50 percent during 2008.

¶3. (U) The results posted in the intervening months, however, have not vindicated expectations, according to Merrill Lynch-Russia Chief Economist Yulia Tsepliaeva. Through June 2008, industrial production rose 5 percent, compared to 7.1 percent from January-June 2007. Retail sales, the most concrete measure of Russia's consumption boom, had grown an estimated 15 percent, compared to 35 percent the previous year. Inflation, moreover, was on its way to exceeding 15 percent for the year by official estimates (with the rate on the middle and lower classes exceeding 30 percent), and the RTS Index had grown less than 10 percent by mid-year.

¶4. (U) Tsepliaeva observed that the reason behind slowing

growth rates in various sectors of the economy was partially explained by investors' concerns about emerging markets in general. According to Tsepliaeva, investors had determined that Russia was not immune to capital tightening affecting firms in developed markets and as a result where less inclined to invest in Russia. As evidence, she noted that IPOs in the first half of 2008 totaled USD 500 million compared to approximately USD 15 billion a year earlier. In addition, private net capital inflows reached USD 12.5 billion through June 2008, compared to USD 60 billion a year earlier.

Inflation as Explanation

¶5. (U) Goldman Sachs Executive Director for Economic Research Rory MacFaquhar agreed that the slowdown in the flow of capital to Russia was part of a general trend affecting emerging market economies, particularly the BRIC (Brazil, Russia, India, China). He argued, however, that Russia's situation was worse than the other BRIC countries because of concerns about Russia's ability to fight inflation (reftel). McFaquhar said inflation accounted for the magnitude of the decline Russia was experiencing in these financial indicators.

¶6. (U) In particular, MacFaquhar said Russia has exhausted the spare production and infrastructure capacity that was available following the collapse of the Soviet Union, which is driving inflation. Consequently, the economy's dominant characteristic was now competition between long-term, capacity-expanding capital needs and current production demands. The result has been higher prices for inputs, from construction material and energy to salaries. Industrial input prices have risen more than 4 percent per month this year; average salaries have risen more than 28 percent from January to June 2008.

¶7. (U) MacFaquhar added that GOR fiscal laxity threatened to exacerbate inflation even further. He noted that Kudrin's three-year budget plan has not survived its first year of implementation without political tampering. Out-year expenditures on the Sochi 2014 Olympic Games and much-needed transportation projects have been moved to this year's budget, according to MacFaquhar. He also contended that the policy shift away from exchange rate targeting toward inflation targeting, which Kudrin announced at the Renaissance Capital annual conference in June, could take as long as five years to become effective.

Comment

¶8. (C) Russia is between the inflation rock and a growth hard place. In the short term, it appears the GOR cannot address one without adversely affecting the other. Although the GOR has already indicated its preference for a pro-growth approach of state funding for infrastructure and innovation projects alike, Kudrin may cite the drop in these indicators of financial health in an effort to revisit curbing expenditure growth during budget amendment meetings in September.
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